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SUBJECT: EGYPT: INFLATION ON THE RISE

Summary

¶11. (U) Inflation began creeping back into Egypt's economy in late spring, as food prices rose in response to an outbreak of bird flu. Prices rose further in late July, when the GOE reduced its massive energy subsidy. Higher fuel costs affected prices across the board, leading the GOE to intervene in a variety of ways to keep prices under control. Despite the intervention, the start of Ramadan further squeezed consumers, who normally spend lavishly during the fasting month. The GOE maintains that economic growth and rising wages are the real driving factors behind inflation. While there is scant evidence to back up the claim to rising wages, consumer spending has increased, prompted by greater liquidity and low interest rates. The tempered reaction of the Egyptian public to rising prices leads many analysts to speculate that the GOE will further reduce subsidies in the near future. The challenge will be targeting the reductions to ensure the poorest sectors of society are not adversely affected. End summary.

Inflation Fueled by Bird Flu, Subsidy Reduction

¶12. (U) After more than a year of declining prices, inflation began creeping back into the Egyptian economy in late spring. From a low of 4.4 percent year-on-year in April, overall inflation has risen steadily over the last six months to 9.5 percent currently. An outbreak of bird flu in January, which devastated Egypt's poultry sector, began pushing up prices of poultry and other meats in April.

The cost of food and non-alcoholic beverages, which has the heaviest weighting (39 percent) in the Consumer Price Index, rose 5.7 percent in April, and continued to climb through the summer, peaking at 11.7 percent in August. Communication costs also shot up in April, as Egypt's telephone monopoly Telecom Egypt raised rates on fixed lines to compensate for losses from competition by mobile phone providers. Telephone rates increased 20 percent monthly from April through June, and 22.7 percent in July.

¶13. (U) In late July, consumers and industries felt more pain as the GOE reduced its massive energy subsidy. Prices of natural gas for industrial use and electricity generation rose by 25 percent, kerosene 88 percent, fuel oil 67 percent, diesel oil 25 percent and gasoline (90 octane) 30 percent. The energy subsidy reduction effected prices across the board, as industries passed on to consumers the increased cost of manufacturing and transportation. Housing and utility costs rose 6 percent in August and September, up from 2.2 percent in July. Cement prices, a key factor in construction costs, increased 10-25 percent in August, depending on proximity to cement factories. Overall ex-factory prices rose from

LE 310-315/ton to LE 350/ton, while in some retail markets, particularly those with no nearby cement factory, prices rose to as high as LE 390/ton.

GOE Intervenes to Control Prices...

¶14. (U) Ironically, the energy subsidy reduction forced the GOE to increase other subsidies. Dr. Abdel Sattar Eshrah, Economic Advisor for the Federation of Egyptian Chambers of Commerce (a joint governmental and business entity), told econoff that bakers complained they could not maintain stable bread prices as more expensive fuel led to higher operating costs. The GOE reduced the price of a case of government flour from LE 20 to LE 14.5 (and revamped its inspections of bakers who obtain flour at the new price to ensure quality). The overall effect on the GOE budget was still positive however, as food subsidies - representing only 2.1 percent of GDP - are less expensive than energy subsidies, which represent 8 percent of GDP. The GOE intervened more directly in the cement sector. Minister of Trade and Industry Rachid met with cement producers in August to persuade them to observe a price cap of LE 330/ton for retail sales and LE 290/ton ex-factory. Although the cap was voluntary, Rachid threatened harsh export tariffs for producers taking advantage of higher prices on foreign markets. He also promised assistance to companies that lost money by adhering to the cap. The plan succeeded, and by the end of the month ex-factory prices fell to as low as LE 300 per ton.

... but Ramadan Increases Consumer Woes

¶15. (U) Despite GOE intervention to moderate prices - including lifting an imported poultry ban to prepare for high demand during Ramadan - the start of the fasting month in late September exacerbated pressure on consumers. Shopkeepers generally exploit consumer willingness to spend lavishly during Ramadan, and weak competition and even weaker consumer protection make predatory pricing easy for suppliers and shop owners. Ramadan coincided this year with the beginning of the academic term, when household discretionary spending traditionally inflates to buy new clothes and school supplies. Press reports lamented the effect of high prices on the poor, and pointed out that public sector wages, and to a lesser degree salaries in the private sector, have not kept pace with rising consumer costs.

GOE Claims Growth is the Real Cause

¶16. (U) GOE officials maintain that the driving force behind inflation is economic growth, rather than external factors. GOE figures estimate a growth rate of 6.9 percent for FY 2005/2006, the highest level in 15 years. Officials also maintain that public sector wages are keeping pace with inflation. Amina Ghanem, an Advisor to the Minister of Finance, told econoff that the annual increase in the public sector wage scale generally offsets higher living costs. The normal increase is 10 percent annually, only slightly higher than the current inflation level. The 2005 increase - a one-time jump of 20 percent - was widely seen as an election year pitch to the public sector by President Mubarak, who was running for re-election in Egypt's first ever multi-candidate presidential election. Given the extremely low base rate of public wages, however, and years of double digit inflation following the floating of the Egyptian Pound in January 2003, most analysts believe the annual increases, even last year's, are not sufficient to meet basic consumer costs and keep pace with inflation.

Despite Stagnant Wages, Consumers Still Spending

¶17. (U) While there is scant evidence of a rise in real incomes, consumption spending has risen. Household credit, a prime indicator of consumption spending, shot up 26 percent in March/April and 28.6 percent in July, compared to only 10.8 percent in October 2005. Liquidity has risen 12-13 percent y-o-y since January 2006,

stimulated in part by last year's 50 percent tax cut. Low interest rates on bank deposits, triggered by low Central Bank rates, have also reduced consumers' incentive to save. The Monetary Policy Committee (MPC) of the Central Bank has held corridor interest rates unchanged since April 2006 (an overnight deposit rate of 8 percent and lending rate of 10 percent), constantly declaring that inflationary pressures are within moderate limits. In its October meeting, however, the MPC signaled the possibility of a rate increase in November.

Reaction Tempered

¶18. (U) Despite grumbling over wages, public reaction to high inflation has been moderate. Local papers have run stories on the harsh conditions for the poor this Ramadan, but grumbling has not turned into protests or violence. The stoic reaction of Egyptian consumers has led some observers to speculate that the GOE will make more subsidy reductions soon. Dr. Tamer Abu Bakr, head of the Petroleum Committee of the Egyptian Businessman's Association and member of the National Democratic Party Energy Committee, told econoff that he expects another fuel subsidy reduction in early ¶2007. The still massive energy subsidy, at least LE 40 billion (USD 7 billion) by most estimates, is responsible for 40 percent of the GOE's budget deficit, which stands at approximately 10 percent of GDP.

¶19. (U) Nevertheless, the GOE will be hard-pressed to further reduce its fuel subsidy without affecting the poorest segment of the population. Hany Kadry Dimian, Director of the Macro-Fiscal Unit at the Ministry of Finance, told econoff that the GOE's aim in subsidy reform is to target subsidies to the poor. This is the reason that the GOE left the price of 80 octane gasoline - the lowest-quality gasoline available - untouched in July. However, according to Abu Bakr, this had an unintended effect, in that people who previously used 90 octane gasoline are now using 80 octane, regardless of the effect on their engines. Future subsidy reductions will somehow have to deal with 80 octane gasoline, which could prove to be a sensitive social issue.

Comment

¶110. (U) While economic growth has outpaced even the GOE's expectations, it has not, unfortunately, translated into job creation. The GOE is therefore faced with the double challenge of maintaining growth while mitigating the negative effect of inflation and subsidy reductions on the poor and unemployed. For the time being, Egyptians seem prepared to take the government's word that growth will eventually lead to jobs, but much of the educated middle class isn't waiting around, and continues to seek opportunities for work abroad. Indeed, remittances from family members working overseas are often the only thing keeping Egyptian families afloat as prices increase, but job opportunities do not. End comment.
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